THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 329 **OCTOBER 2000**

Bear markets do not last unless coinciding with and independently induced by depressions in general business.

Joseph Schumpeter, *Business Cycles*
McGraw-Hill Book Company, Inc., 1939

FIVE MINUTES TO TWELVE

Unexpectedly, the major central banks intervened to support the euro. The U.S. government rocked the oil market by announcing the release of some of its strategic oil reserves. And a profit warning from chipmaker Intel prompted a heavy global sell-off in technology stocks.

If the central banks are fortunate, they may have put a floor under the euro. While America's participation is a great surprise, U.S. Treasury Secretary Lawrence Summer was quick to soften its bearing on the markets by repeating that the long-standing U.S. policy on the dollar had not changed: "As I have said many times, a strong dollar is in the interest of the United States." In fact, U.S. policymakers are sternly opposed to any lasting reversal in the fortunes of the dollar. What may have caused them to join the intervention could have been the threat of the European Central Bank to raise its interest rates still further, risking weakening economic growth in the region.

Nonetheless, we continue to wait and to look for the dollar's impending collapse, like in 1985. Principally, what has been happening these days between the dollar and the euro is amazingly similar to what occurred in the first half of the 1980s. At the time, the world was bombarded with stories that the U.S. economy was enjoying miraculous, structural improvements owing to "supply-side Reaganomics." In line with it went the contemptuous story about Europe's economy, dubbed "Euro-sclerosis." Everybody agreed that the dollar's strength was well-grounded in the U.S. economy's lasting superior growth performance.

We have vehemently assailed these views in this letter, pointing out that in reality, the dollar derived its strength from unbridled government and consumer borrowing, while investment spending was going downhill. We warned that the first weakening of U.S. economic growth would initiate the dollar's collapse. In fact, stopping the dollar's surge in 1985 by joint intervention actually cost the central banks less than $10 billion of their reserves. But to prevent the dollar's freefall in 1987, they had to buy almost $100 billion in a single year and several hundred billions in the following years.

What is the difference between then and now concerning the U.S. economy and the dollar? Today's talk of "new paradigm" miracles is just as empty as the talk in the 1980s of supply-side miracles from Reaganomics. Yet there is one very important difference: The credit excesses of the late 1990s have been many times worse than those in the 1980s, and so are, accordingly, the imbalances in the economy and the financial system. Just think of the zero personal savings rate and the stupendous trade deficit. To speak of the U.S. economy's excellent fundamentals in the face of these disastrous facts requires a lot of stupidity.

The dollar's decline and eventual collapse will start once the economic news begins to disappoint. As we expose in this letter, there is already far more weakness in the U.S. economy than the headlines suggest. But nobody cares to také notice.

EUROSHAME

It is hard to decide what is more painful to watch, the pitiful weakness of the euro or the pitiful helplessness of Europe's leading politicians and central bankers. By now, it is embarrassing to watch them. Europe's economy is in good shape. Inflation is consistently lower than in the United States despite soaring import prices. Economic growth is robust. The region's current account is balanced. Growth and interest rate differentials go some way to explain a weaker euro against the dollar, but they are far from explaining the near-collapse of 27%. There is every indication that the euro's steep fall is a classic case of self-reinforcing exchange rate overshoot.

Despite the euro's woes, it remains our conviction that the greatest threat to world economic and financial stability is the dollar's impending collapse. It definitely has precarious strength, chiefly derived from two bogus influences. One is the magic spell of the new paradigm propaganda to which the whole world has naively succumbed; the other one is the tremendous pull of unbridled American domestic credit demand heavily spilling over into the euro-zone's financial markets. Compared to these two powerful influences, Europe's leading politicians and central bankers give the impression of a bunch of people that have neither concept nor will. Unfortunately, it is true. Of the self-confidence of the former Bundesbank people, there is absolutely nothing left.

First of all, everybody knew perfectly well that the Bundesbank was keen on a strong currency under all circumstances. And everybody also knew that the people at the Bundesbank also had no qualms to intervene with aplomb in the markets when they judged it appropriate. Nor was there anybody who felt entitled to lecture them that interventions are risky and only distort markets. What's more, their interventions had the habit to prove highly effective. Effectiveness or ineffectiveness of interventions essentially depend on the health or ill-health of the economy. Massive interventions failed in 1992 to stabilize the pound because Britain's economy and balance of payments were in horrible shape. Europe's economy is in good shape.

A BIT OF INTERVENTION HISTORY

For sure, the Bundesbank preferred coordinated interventions. Yet it didn't mind to act in splendid isolation The most famous case of concerted intervention is, of course, the Plaza Agreement of Sept. 22, 1985. It is also highly instructive. The secret provisions of the agreement foresaw interventions for a period of up to six weeks with the target to initially knock 10-12% off the dollar. Overall, the central banks committed up to $18 billion divided roughly by thirds among the United States, Japan and Germany/Europe. Then all would be reviewed.

Ironically, the participants entertained exactly opposite worries. Whereas the finance ministers mainly feared that the interventions would fail to stop the dollar's ascent, the central bankers, including Paul Volcker mainly worried about the possibility that aggressive dollar sales would scare international capital and trigger an unstoppable decline of the dollar. But the mere announcement of the arrangement had an immediate, powerful effect. Even before the intervention started on Monday morning, the dollar had already started to plunge. It fell 4.3% for the day. Within the first week, the G5 central banks sold a mere $2.7 billion altogether. By the end of the week, the dollar had lost 12% versus the yen and nearly 8% against the DM.

Over the next five weeks the largest concerted intervention operations of the central banks against the dolla

unfolded. Remarkably, it was far more effective than originally expected. The targets of dollar devaluation were fully met within the stipulated time: 13% against the yen and 10.5% against the DM. But the costs in terms of sold dollars proved far lower than expected. Dollar sales during the whole period totaled only $8.2 billion, rather than the $18 billion war chest at the ready. Two years later, the central banks were desperately buying dollars in order to prevent its freefall.

EUROPE'S LARGE DOLLAR HOARD

Today, as a matter of fact, Europe's central banks sit on a huge dollar hoard of $222 billion altogether. One of the arguments against selling dollars is that it would come at a heavy cost to the ECB's exchange reserves because stabilization of the weak euro would probably require repeated rounds of dollar sales. But what is it that makes these reserves so precious that any larger reduction appears undesirable and hazardous? Nothing but foolish thinking. Under a system of floating exchange rates, it would be reasonable for central banks to hold their foreign exchange reserves at the necessary minimum, and in the case of the ECB that would be a fraction of its present dollar holdings.

The bulk of these dollar reserves have accrued from virtually persistent dollar purchases by national central banks to prevent an undesired depreciation of the U.S. currency against their currencies. In this light, it seems perfectly natural that these same central banks ought to seize the opportunity of periods of dollar strength to reduce their dollar holdings again. But that is absolutely taboo. The prevailing perception is that dollar reserves of central banks have but one way to go: up, up and up. Meanwhile, it has somehow become dogmatic that any dollar selling by central banks is risk-fraught and something completely out of the ordinary, violating the holy spirit of free market forces, while dollar buying by central banks rarely gets mentioned in the media.

We wonder: What would happen to the euro-dollar exchange rate if the ECB declared that it had deemed its dollar reserves vastly excessive, and had therefore decided to unload about $50 billion within the next few months? To be sure, the mirage of dollar strength would vanish within minutes. It would cause panic. We don't see anything that could reasonably be said against an action of this kind. Under a system of floating exchange rates, such a decision appears absolutely rational.

What, really, speaks against larger ECB dollar sales in order to prop up the euro against the dollar, and what speaks in their favor? In the first place, the markets ought to learn to be just as relaxed about dollar selling by central banks as they are about dollar buying on their part. Any central bank is entitled to reduce its dollar holdings, and what better timing than to do so when the dollar is strong? What primarily and decisively speaks against dollar selling by the ECB is strong contrary American interest. The U.S. financial system's stability crucially depends on unwavering confidence in the U.S. dollar's long-term strength. The emphasis is on two words: "confidence" and "long-term."

A CONFIDENCE GAME

In the face of the U.S. gargantuan current-account deficit, all that needs to happen to start an unstoppable decline of the dollar with disastrous consequences for the U.S. financial system is something to shake this confidence. Even if capital flows are not immediately diverted, it would at the very least trigger an avalanche of precautionary hedging against the possibility of a dollar decline, and that could already be enough to radically change the fortunes of the dollar. Considering that gross foreign dollar holdings today exceed $7 trillion, there

is clearly a vast potential need for hedging. Given the present conviction in the market that the dollar can only rise against the euro, hedging has essentially become completely one-sided. Everybody hedges against a falling euro, but nobody hedges against a falling dollar.

As to currency weakness or strength, there are two opposing interests in every country. Financial interests principally favor a strong currency because it tends to pull in foreign capital. Manufacturing interests traditionally tend to favor a weak currency as a stimulant to exports. When James Baker, the U.S. treasury secretary in 1985, consented to drive the dollar lower in concerted interventions among the G5 central banks, he did so primarily with regard to the damage that the overvalued dollar was doing to America's manufacturing base, as opposed to the interests of Wall Street and the financial markets that wanted and badly needed a strong dollar.

Comparing the situation of today with that in 1985, we see two critical differences. The one is in the degree of dollar appreciation. When the G5 central banks started their coordinated interventions, the dollar had doubled in value against the European currencies within three to four years, for example, rising from DM 1.75 to DM 3.47. This compares with the recent rise against the euro by about 27%, with the German currency hitting DM 2.30. But against the yen, the dollar has plunged. Next is America's booming exports. During August, they ran 27.4% levels against a year ago. What fuels the soaring trade deficit is an even faster increase in demand-propelled imports, up 54.6% year-over-year.

THE SECRET FEAR

In 1985, the joint interventions had the explicit aim to drive the dollar down. This time, for sure, the aim is much more limited. Nobody really wants a falling dollar. Once it starts, it would be hard to stop. A potential freefall of the dollar is effectively the biggest nightmare of policymakers on both sides of the Atlantic. A few months ago, the Bank for International Settlements in Basel warned that the biggest policy challenge for the world's central banks was a possible sudden reversal in the fortunes of the dollar. Next the Bank of England called a precipitate fall of the dollar the greatest single risk for the British financial system.

The most recent warning has come from the International Monetary Fund. In a just-published report, it says that "the widening of the U.S. current account deficit could shake investors' faith in the nation's economy, triggering a withdrawal of investment that could endanger global markets…Financial shocks can propagate across institutions and markets in new and surprising ways…If the growing integration of global markets is the chief risk, the United States poses the biggest challenge since it is by far the world's largest. So a reversal in sentiment about the United States would have worldwide implications." One remarkable thing about such warnings is the minimal publicity they get.

Quite a few of the central bankers behind the euro surely share these worries about the potentially fragile dollar. The one and only force that has kept propelling the dollar ever higher in the current-account deficit is the euphoric perception and expectations about the future performance of the economy. The two will soon be pricked by disappointing news about growth and profits. The favorite explanation for the strong dollar is that Corporate Europe is stampeding into the super-performing U.S. economy, primarily through direct investments and acquisitions.

Before commenting on this, first some general remarks. As for the strong dollar, it tends to be overlooked that U.S. capital inflows have to finance not just the soaring current-account deficit, but also huge capital outflows. The gap in the current account has soared from $220.6 billion in 1998 to presently more than $400

billion. Last year's U.S. capital outflows of $378.2 billion compared with $209.8 billion in 1998. To accommodate both flows required an overall net capital inflow of no less than $750 billion. The dollar's strength suggests that actual inflows tended to exceed this amount.

In the first quarter of 2000, the U.S. current-account deficit hit $102.3 billion, now exceeding $400 billion at annual rate. This new record of red ink on current account was matched by a considerably higher capital outflow of $143.3 billion. Annualized, the two added up to a requirement of capital inflows of a stunning $984 billion.

BORROWED STRENGTH

It stands to reason that the dollar's further stability depends on the perseverance of capital inflows of preposterous magnitude. Still, the reality is conveniently ignored. The story being played in the global media like the proverbial broken record is that the euro's weakness, apart from its fumbling politicians, has its overriding cause in a stampede of European companies buying U.S. outfits, large and small, desperate to participate in the superior U.S. economy's performance in growth, productivity and profits. As European companies convert billions and billions of euros into dollars, the euro hits low after low. The important thing about this explanation is that it appears to have a "structural" cause, and anything called "structural" inherently implies long-run durability.

Like so many stories, this one, too, contains very little truth. True, the U.S. capital account registers direct investment inflows of $282.5 billion for 1999, mainly from Europe. That's a big number, yet the first thing to see is that it accounted for barely one-third of total capital inflows in 1999. Second, more than half of total direct investments from Europe came from Britain. And third, by far the greatest part of these flows reflects a relatively small number of big acquisitions and mergers that were overwhelmingly financed by an exchange of stocks, meaning that they bypass the currency markets. It's absurd to attribute the euro's weakness to these transactions.

The biggest single item among *recorded* U.S. capital inflows, is, in fact, borrowing by corporations and federally-sponsored agency bonds. And their borrowing effectively implies the conversion of euros into dollars. Together, they amounted to $255 billion in 1999 and to $71.7 billion in the first quarter of 2000. Quoting from a Commerce Department report: "U.S. agencies, in particular, have sharply stepped up their sales in international markets as part of their continued effort to expand the frequency and size of their issues in all markets." Keep in mind, the latter number is not annualized. In other words, dollar strength is clearly borrowed strength, not structural strength.

There is, in fact, a rapidly lengthening list of U.S. corporations borrowing in euros. It's cheap and it's a falling currency. But second-quarter data show another American borrower drawing funds heavily from abroad: American banks. Ample liquidity in the Eurodollar markets offers them a comparatively inexpensive source of short-term funding to support their soaring domestic credit expansion. In the second quarter, U.S. banks increased "due from foreign affiliates" by $55 billion.

APROPOS AGENCIES

Since we mentioned it, who are the "federally-sponsored agencies"? Their exact name is Government-Sponsored Enterprises. Three of them are very important for the U.S. credit markets: Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. In past letters, we have repeatedly reported about their insatiable

appetite for borrowing and lending. They borrow funds, short and long, and then use them to buy mortgages from the original lenders. Though privately owned, their debt obligations are backed by "the full faith and credit" of the U.S. government, including a credit line with the Federal Reserve. Officially, they are charged with the task to "provide a dependable supply of credit at the lowest cost possible to disadvantaged borrowers, meaning borrowers for which credit is either too limited, too variable or too expensive."

But something strange has happened with these three institutions. They began the 1990s with total assets of approximately $450 billion. Until 1993, these were up to $631 billion. Then the pace of their expansion has progressively accelerated. At end-1997, assets and liabilities hit $1,099 billion. By mid-2000, they had already exceeded $1,800 billion.

Judging by the exploding balance sheets of the three GSE's, most Americans nowadays seem to rank as "disadvantaged borrowers." The combined total assets of the three expanded $109 billion during the first half of 2000. Compared to the recent past, that's unusually low. Over the last 12 months, their assets and liabilities have grown $288 billion, and in the past 24 months an astounding $612 billion...yes, $612 billion in the past two years. Poor euro. Freddie Mac has already announced it will borrow €60 billion over three years, €20 billion each year.

Pursuing the activity of these institutions, we further note that they regularly become aggressive buyers during key periods of financial stress. At critical junctures, the GSEs, with implied government guarantee, have proved willing and able to function as buyers of last resort for mortgage-backs, much to the delight of the highly leveraged speculating community. During periods of faltering credit system liquidity, the GSEs borrow aggressively from the money market, using this liquidity to then aggressively purchase mortgages and other debt instruments. Combined, they ended 1999 with more than $660 billion of short-term debt and more than $1 trillion of derivatives. The most striking incidences of this kind were in 1994 and 1998.

In order to fully grasp the true role of these agencies on the U.S. financial system, you have to compare their actual borrowing and lending binge with the minimal finances actually needed for residential building. It increased during the past 24 months by $64 billion in current dollars, from $359.6 billion in the second quarter of 1998, to $423.6 billion in the second quarter of 2000. Not exactly a building boom. Nevertheless, outstanding mortgages jumped during the same period by $689 billion. For each additional dollar spent on new residential building, there were 10 additional dollars in new private mortgages.

The specific cause behind this ludicrous gap between new mortgage borrowing and new residential building hardly requires explicit explanation. It's common knowledge. Millions of American families have been using their home as a cheap and easily accessible cash cow for purchasing power. Accumulated stock market wealth, of course, is much larger and has risen much faster. But it is also concentrated in far fewer hands, while over two-thirds of American families live in homes they own. While the booming stock market has fueled the general over-confidence, it's the easy ability to tap money out of the family home at low interest rates that chiefly finances the consumer spending spree.

It is an open secret what the consumers do with the money from their "home equity borrowing." Since 1995, outstanding home mortgages have soared by about $1.5 trillion, which is roughly twice the amount of such borrowing in the preceding five years. Some of the borrowed money was, of course, spent on durables and nondurables — that is, it went into a higher living standard. But the greater part of that "cash out" refinancing, where home owners get cash upfront in exchange for a bigger mortgage, was probably piled into the stock

market.

It was the allusion to a sharp rise in foreign borrowing by government-sponsored agencies in the report of the Commerce Department about "U.S. International Transactions, First Quarter 2000" (*Survey of Current Business*, July 2000) that induced us to a brief description of the activity of these institutions. But back to the travails of the euro and our statement that U.S. corporate and agency borrowing definitely represent the single biggest component on record in the U.S. capital account statistics.

TWO BIG INVISIBLES AT WORK

Net recorded capital inflows — total inflows minus total outflows — amounted to $71.7 billion in the first quarter. Still, that substantially lagged the current-account deficit of $102.3 billion and therefore implies unidentified capital inflows of $30.4 billion, virtually the same amount as in the fourth quarter of 1999. In the statistics, this ranks as "statistical discrepancy" or "errors and omissions."

We come to two flows that probably play the crucial role in depressing the euro. What's happening here are the regular features of every self-reinforcing currency crisis in history. After all, it now seems opportune to speak of an outright euro crisis. First, there's one-sided hedging against a falling euro through the futures and derivatives markets; and second, one-sided lengthening in the terms of payments against the euro, so-called leads and lags. Although both forces typically play a dominant role in putting a "weak" currency under self-aggravating selling pressure, they completely escape statistical measurement.

The decisive condition for this to happen is that expectations about the movements of a currency turn totally one-sided. It has become the consensus opinion that the euro can only depreciate against the dollar, and this perception essentially induces and even compels investors as well as importers and exporters to protect themselves, one way or another, against this generally recognized risk of further euro depreciation. Even if most of them have no intention of actual bear speculation in the euro against the dollar, in practice the one-sided operations produce exactly the same result of self-aggravating selling pressure. Just the opposite applies to dollar holders. Expecting nothing but further appreciation, everybody is happy to be long dollars, keeping his position unhedged.

The other invisible, big culprit in every currency crisis is a lengthening or shortening of the leads and lags; in other words, a change in the timing of payments for imports, or in the practice to cover the exchange risk on such payments. Importers in Euroland, expecting further dollar appreciation, are sure to settle their dollar liabilities as early as possible. They may even buy the dollars forward, while foreign buyers of goods from Euroland, expecting a falling euro, will tend to delay their payments to the latest possible date. In the last analysis, it boils down to the fact that the trade financing between two regions shifts increasingly toward the depreciation-prone currency, and this shift, though invisible, runs into gigantic sums.

Earlier we said the biggest single component in recorded U.S. capital inflows is corporate and agency borrowing. But please note that we speak explicitly of *recorded* capital inflows. The reason is that we regard these invisible operations, taking place through the derivatives markets and changes in lead and lags, as the most important influences behind the chronic euro weakness.

BACK TO THE KEY QUESTION

Paraphrasing the old saying that all roads lead to Rome, it holds good today to say that all economic and

financial questions in the world lead directly or indirectly to *one* perennial question: soft or hard landing for the U.S. economy? As we have repeatedly argued, the euro's crisis has its primary cause not in actually bad economic conditions in Europe, but in the extraordinary "magnetism" of the U.S. economy and its financial markets, and this magnetism has two main sources: the spell of the new paradigm mirage, and the pull of insatiable U.S. domestic credit demand spilling over into Euroland's vast credit market.

In hindsight, it is easy to say that these two influences suffice to give the dollar a boost. Yet the euro's pronounced and prolonged weakness contrast strangely with the good news about the economy: 3.8% real growth at annual rate in the second quarter; an average inflation rate of 2.4%, despite soaring import prices; and a balanced current account. Even employment for the last two years shows an impressive rise. Essentially, the currency's sickness has nothing to do with the economy. Economically, it is incomprehensible.

In the last letter we said the ugly truth seems to be that, whatever positive happens in the euro zone, the U.S. economy is seen to be doing much better. Just think of the raptures about the recent stellar U.S. GDP and productivity numbers. Far from cooling, the reports about America's productivity miracle are getting ever more euphoric.

A closer look at the U.S. economic data tells us that there is far more vulnerability and weakness in the economy than the consensus reports take cognizance of and reflect. At the same time, we notice a strong consensus to trumpet any little piece of negative news in any European country, while good news is neglected, if not entirely ignored. Since the euro-zone consists of 11 countries, it is easy to find something negative somewhere.

FAITH OUTRUNS REALITY

Yet, despite all this reporting, we see no reason to change our forecast of an impending hard landing for the U.S. economy with a collapsing dollar. Outside of the United States, it is quite a widespread view. Although the duration of the dollar's strength is a great surprise for many, they remain convinced that its crash is inevitable. It seemed likely that falling stock prices would hurt the dollar. But so far it hasn't, proving thus, by the way, that the dollar's strength is not related to the stock market. To topple the dollar, we assume, would take seriously disappointing news about the U.S. economy to shatter the "new paradigm" mirage.

Such news is proliferating. But the intense preoccupation with the impending "soft landing" has insulated the thinking on Wall Street and in the markets from any statistics that seem to disturb this rosy expectation. Weak data are principally benign and correspondingly hailed by the markets. Blind faith is outrunning the facts.

Yet there is more than blind faith at work. There is the beauty of "hedonic price indexing" and the capitalization of software expense, as well as the high-octane "new paradigm" propaganda, in which no one indulges more than Mr. Greenspan. His single-minded emphasis in trumpeting technological miracles compares oddly with his complete silence on the unprecedented money and credit excesses that he keeps fueling. This can't be just by chance. This is systematic, purposeful misinformation coming from a person who perfectly knows that he enjoys the highest credibility in the world. For sure, he knows equally well how important it is to keep up the appearance of what he has been preaching.

Correlative to the prevailing overwhelming propensity to perceive only "good" news about the U.S. economy is an equally overwhelming propensity to ignore proliferating truly good news about the European economy. Strikingly, any ever so slight dip in European economic data finds disproportionately large coverage

in comparison to the numerous good news. Still, we doubt that this differential treatment is deliberate. It simply corresponds with the prevalent grossly differing perceptions. Unfortunately, European policymakers contribute their fair share to discredit themselves. Compared to the wily Mr. Greenspan, they appear rather helpless.

Nevertheless, forget Mr. Greenspan, forget Mr. Schröder and forget Mr. Duisenberg, because in the long run it's facts and fundamentals that govern markets, and the long run is approaching fast for the U.S. economy and the dollar.

What will prick the American bubble? That's the all-important question at this juncture. We think that needle will be disappointing economic news that will shatter the new paradigm mirage.

EUPHENOMICS

Soft landing, hard landing, crash-landing — they all essentially start in exactly the same way: with a moderate slowdown. The question that requires a little thinking is, what happens next? Actually, this initial slowdown has definitely arrived in the United States. But instead of scrutinizing the flow of data with a critical eye, everybody has instantly jumped at the foregone conclusion that this is the start of the glorious "soft landing," implying that the economy will briefly slow down before returning to full speed again. Just keep in mind, though, that the Fed and Wall Street have a long tradition of recognizing recessions or depressions long after they have started. The euphoria about the New Economy shuts the eyes to anything negative.

Economics has traditionally been known as the "dismal science." But looking at the U.S. economy, every economist is determined to ignore anything negative and put a rosy spin on anything that happens, whether collapsing savings or the soaring trade deficit. Characteristic of this preconceived approach is the gross misinterpretation of the second-quarter GDP figures. The announcement of 5.3% real GDP growth and even 5.7% productivity caused nothing but jubilation. Productivity-enhancing IT investment is rapidly raising the economy's safe "speed limit," according to the united conclusion. Robert T. Parry, president of the Federal Reserve Bank of San Francisco, recently opined that the economy's potential growth rate this year and next was 5%. In this way, the data for the quarter inspired unbridled optimism.

In reality, the Commerce Department's revised second-quarter GDP data are anything but a reason for jubilation. In order to recognize that, though, it needs a closer look into the aggregate. First of all: fully 50% of the GDP growth in the quarter has come from government spending and inventory stockpiling. Consumer spending growth, on the other hand, has more than halved from $112 billion in the first quarter to $45 billion in the second quarter. Growth in nonresidential fixed investment slowed sharply from $63.5 billion to $47.5 billion, and residential building was absolutely flat, all numbers at annual rate. In addition, the drag of the trade deficit had increased from 0.94 percentage point to 1.20 percentage point of GDP. Would you say that this is a healthy, balanced economic growth pattern? Definitely not.

INCOMPATIBLE STATISTICS

Not only most astonishing but also most important is the sudden, drastic slowdown of consumer spending in the second quarter. What is behind it? Is it just a freak occurrence? Or are there reasons to assume that this could turn into persistent weakness? If so, it's time to prepare for a hard landing of the U.S. economy.

In the last letter, we argued that the prolonged disappearance of wealth effects in the stock market speaks for a genuine, lasting break in consumer spending which, in turn, hurts stock prices by squeezing corporate

profits. The few data that have come out since definitely suggest that a lot more weakness is developing in the economy than the consensus wants to see and believe.

The first reasonable assumption is that consumer borrowing is being restrained. That's an error. What has happened is something very strange and very ominous. The consumer has been running out of growth in his real disposable income. (See both the table and chart.) And bear in mind, this virtual collapse in income growth has happened in the midst of a record economic expansion with record productivity gains. First the facts, then the explanation:

UNITED STATES: REAL GDP AND REAL DISPOSABLE INCOME (INCREASE IN %)

	1998	1999	1999				2000			
			I	II	III	IV	I	II	JUNE	JULY
REAL GDP	4.4	4.2	3.5	2.5	5.7	8.3	4.8	5.3		
REAL DISPOSABLE INCOME	4.8	3.2	2.9	2.8	2.2	4.5	1.9	3.3	0.0	0.1

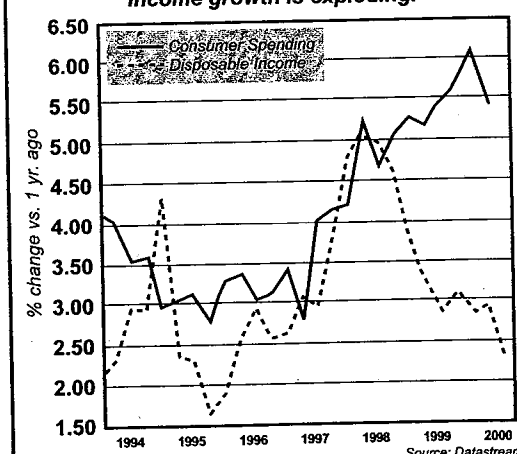
While GDP remains strong, real disposable income—America's buying power—is on the decline.

Source: Survey of Current Business

Yes, the American consumer is rapidly running out of new buying power. But if you think it's due to credit restraint, you are grossly mistaken. This restraint is coming from a highly surprising and, above all, ominous source: sharply lagging growth of personal real disposable income. Normally, GDP and incomes should grow in lockstep. But please compare the two rows of numbers in the table above. Real GDP growth (upper row) has gone from strength to strength. But the growth of real disposable income (lower row) has virtually collapsed. In the same vein, the following chart shows an exploding gap between spending growth and income growth. Given stagnant real disposable income growth, higher consumer spending now depends fully on new borrowing.

Real Consumer Spending vs. Real Disposable Income

The gap between spending growth and income growth is exploding.



Source: Datastream

When the Commerce Department announced the U.S. GDP growth rates for the second quarter, economists and markets went ecstatic. Just imagine, so late in the boom: real GDP grows 5.3% and overall productivity grows 5.7%. Obviously, the overwhelming majority of economists saw nothing but these two awesome numbers. The various negative signs, as described above, were completely ignored. Above all, nobody took notice that the stellar GDP and productivity numbers were at gross variance with the sliding real income numbers. And as to business profits, isn't Wall Street choking on an ever-growing list of corporate profit warnings? How is this possible with productivity growth of more than 5% and stagnating real wages?

THREE GRIDLOCKS

Looking for an explanation of this real income squeeze, we identify three major forces: the rising inflation rate, the soaring trade deficit and the hedonic price indexing creating a lot of statistical noise.

There is a lot of boasting about America's low new paradigm inflation rate. At 3.5% year-over-year, it is nevertheless the highest among major industrial countries. In any case, it's enough to eat up total current wage increases. Real wage rates have been effectively stagnating since early 1999. During the three months to July

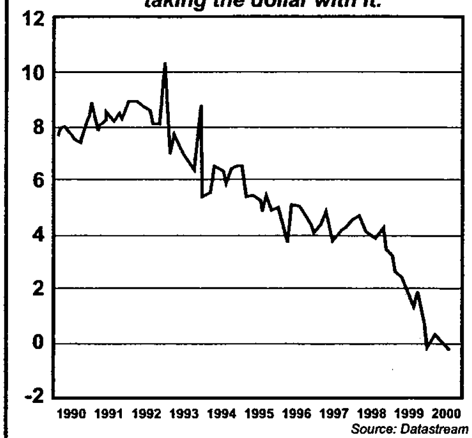
2000, total personal income has effectively risen $78.4 billion in current dollars, but merely $20 billion in real terms. Thus, three-fourths of the increase vanished in price inflation.

Inflation is the one factor capping real income growth. Another is stagnating and even declining work time. Hours worked is a good proxy for GDP growth. Well, they dipped 0.3% in August from July, when they barely rose from June. With no gain in hours, all the third quarter's GDP growth has to come from productivity gains and credit-financed spending.

Now to the trade deficit. For many American economists, it's not a problem, but an emblem of America's outstanding economic strength. They are obviously unaware that a trade deficit of such preposterous size essentially acts as a savage income and profit squeeze on the whole economy. In order to maintain the domestic spending level, it needs ever-bigger credit injections to offset the trade-related drag on incomes and profits. The implicit result is the unsustainable, widening gap between spending growth and domestic income growth. There is nothing new about these effects, except that in the U.S. case they are now running into an onerous magnitude for the economy.

U.S. Personal Savings Rate

With negative savings, the consumer spending boom will run out of gas... taking the dollar with it.



We come to the third force mainly fueling the rapidly growing divergence of real GDP and productivity growth in relation to real income growth. While productivity gains beat ever-new records, income and profit gains are vanishing. And nobody even notices the gross incompatibility of these numbers.

U.S. Current Account

The monstrous trade deficit is increasing, impeding economic growth.

What's to blame? We have identified our old friend, hedonic price indexing, as the most responsible culprit. Measuring computer power with the hedonic deflator, as explained in the last letter, creates more and more fictitious real GDP growth and more and more fictitious productivity growth in line with it. But the resulting real GDP growth has one peculiar feature: complete absence of correlated income creation. No dollar is spent, no dollar is received. Pondering this, we keep asking ourselves, what kind of prosperity ~~is this where the average American has~~ stagnating real income? It has been great prosperity ~~in and~~ through the stock market, ~~yes, but outside the stock market~~ there is zero prosperity.

THE TRIGGER

Back again to the two all-important questions: What will prick the U.S. bubble economy, and when? We say disappointing economic news, shattering the new paradigm myth, will be the decisive trigger. As to the timing, the August letter carried the headline: "At the Critical Juncture." We regard the loss of personal income growth and the lengthening list of corporate profit warnings as compelling indicators of swiftly escalating U.S. economic weakness. Against this background, the general decline in stock prices can only accelerate and, thus, reinforce the economy's developing slowdown. What the bullish consensus refuses to see is that the two most

dangerous imbalances resulting from the credit excesses have grown to such exorbitant size that they are now increasingly impeding economic growth. Negative effects are overtaking the former positive effects. We are speaking of the monstrous trade deficit and the equally monstrous negative personal savings rate.

Yet the American credit machine continues to fire on all cylinders. Total credit (non-financial and financial) has expanded at an annualized rate of $1.84 trillion in the second quarter, after $1.55 trillion in the first quarter. While residential building stagnated, mortgage debt exploded at an annualized rate of $687 billion, comparing with an expansion by $179 billion in 1994 and of $202 billion in 1995. But the salient point to see is that the borrowing and spending binge has drastically diminished effects both on the economy and the markets.

Consumer spending, stimulated by soaring stock market wealth, has been the main engine of the U.S. bubble economy. But those wealth effects have gone into reverse. For the year so far, the Dow is down about 5%, the Transports about 10% and the Nasdaq about 6%. Utilities are up about 40%, the Russell 2000 is up about 5% and there is nothing in sight that may bring the bull market back to life. As we shall explain in the next letter, profits are sure to become the market's growing worry in the coming months.

CONCLUSIONS:

U.S. stock prices across the board have been sliding in response to multiplying profit warnings. The favorite reason advanced by the corporations is that their earnings are spoiled chiefly by the weak euro. An appropriate question remains: How is this broad deterioration of profits possible against the background of soaring productivity gains and virtually stagnant real wages?

We offer two other explanations for the sudden profit deterioration: first, a sharply slowing economy, and second, corporations are finally running out of accounting gimmicks and stock market wealth effects.

Nevertheless, the established euphoria continues to prevail among consumers, businesses, investors and economists. The consensus keeps expecting a continuation of the economy's stellar performance. The U.S. economy is expected to show its strongest growth since 1984 by the end of this year, while the interest cycle has peaked, according to the National Association of Business Economics, a prominent group of 3,000 professional economists and corporate executives.

We repeat what we have said many times before: It will come as a great surprise how fast the U.S. economy will weaken within the near future. And to repeat the warning expressed in the headline: It's five minutes to twelve.

THE RICHEBÄCHER LETTER

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For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1217 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (1-888)433-1528, or from outside the U.S. by calling (1-410) 234-0691. Fax (1-410) 223-2553. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.